

2007-04  
April 24, 2007

## Bulgaria (the Republic of)

**Foreign LT: BBB→BBB+/Stable, Local LT: BBB+→A-/Stable (Upgraded on November 29, 2006)**

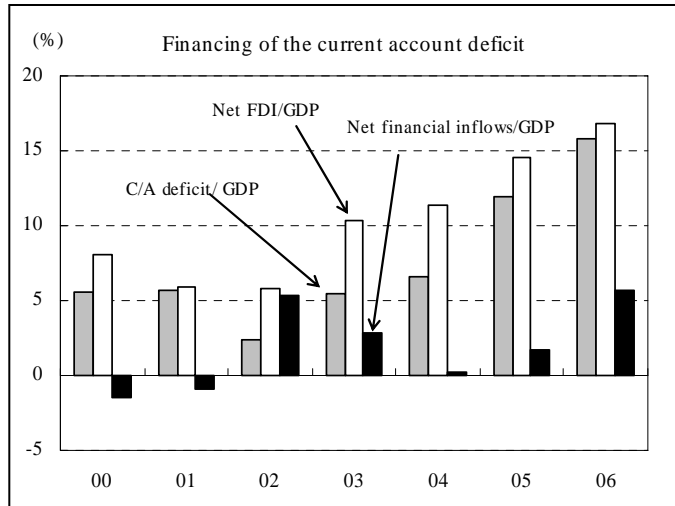
### <Rating Perspective>

#### Positive Factors

- High economic growth prospects following the EU accession.
- Prudent fiscal management and considerable reduction of government debt.
- Stability of currency and inflation underpinned by the currency board arrangement.
- Increasing exports on expanding production capacity rendered by inflows of foreign direct investment.

#### Negative Factors

- Widening current account deficit on robust domestic demand.
- Transformation of industrial structure still at primary stage.



### **Updated: from January 2007 to March 2007**

#### Positive Factors

- The general government fiscal balance in 2006 registered a substantial surplus equivalent to 3.6% of GDP (BGN 1,756 million), a major improvement from 2.3% in 2005.
- Fiscal surplus at the end of 2006 grew 30% year-on-year to BGN 5,846 million or equivalent to 11.9% of GDP.
- Real GDP growth rate in the October-December quarter of 2006 slowed to 5.7% year-on-year, the level closer to sustainable expansion.
- The inflows of foreign direct investment in 2006 swelled to hit a record EUR 4,227 million or equivalent to 16.8% of GDP.
- Net financial inflows centering on portfolio investment and bank loans totaled EUR 1,413 million in 2006 and foreign exchange reserve rose to EUR 8,926 million at the end of the year, both the highest on record.
- Privatization of Bulgaria Air and district heating company Plovdiv has been completed.
- Unemployment rate in February 2007 fell to 8.2%, the lowest on record.

#### Negative Factors

- Current account deficit in 2006 widened to 15.8% of GDP (EUR 3,978 million) from 12.0% in 2005.
- Bank lending to the private sector resumed accelerating to register a 28.0% year-on-year growth in January 2007.

## <Outlook and Points to Watch>

### *A return to sustainable growth*

#### **(1) The economy slows on the continued tight fiscal and monetary policies**

After years of robust growth, the Bulgarian economy has begun decelerating to the level closer to sustainable expansion. Real GDP growth rate in 2006 remained unchanged at 6.1% from the previous year, but it slowed moderately to 5.7% in the October-December quarter of that year. While fixed capital investment continued strong, consumer spending showed a marked deceleration. Furthermore, net exports continued to contribute negatively to the economic growth. Imports slowed down on weakening domestic demand but exports decelerated faster due mainly to the appreciation of BGN (against USD). The consumer price inflation picked up in the first half of 2006 due primarily to the surge of food and energy prices as well as hikes of excise duties, but slowed down to 4.5% year-on-year in February 2007 as the impact of those special factors wore off. The strong economic growth has had a favorable impact on employment. The unemployment rate fell to 8.2% in February 2007, renewing a record low. Bank lending to the private sector, which had been on the downtrend, has begun to gather steam following a decision in October 2006 by the Bulgarian National Bank (BNB) to remove its credit restrictions (which came into force in January 2007). However, the country's financial system remained stable in the absence of any deterioration of bank assets under BNBs stringent

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supervision.

JCR holds that the annual economic growth rate will return to sustainable levels of around 5% in 2007 and 2008 as a series of tight fiscal and monetary policies taken since 2004 to curb the robust domestic demand have proved effective in slowing down the expansion.

## (2) Sound fiscal policies generate a substantial fiscal surplus

The general government fiscal balance in 2006 registered a substantial surplus (BGN 1,756 million) equivalent to 3.6% of GDP, up from 2.3% in 2005. While tax revenues grew markedly on the economic expansion and tightened tax collection, expenditures were largely in line with the levels projected in the budget. As a result, the fiscal reserve account balance swelled to BGN 5,850 million at the end of 2006 or equivalent to 11.9% of GDP. The government had initially envisaged a balanced budget for 2006, but revised it to produce a surplus equivalent to at least 3.0% of GDP, based on its agreement with the IMF aimed to reduce the current account deficit. This target was attained. The general government fiscal debt at the end of February 2007 decreased further to 22.4% of GDP from 25.6% at the end of 2006. The budget plan for 2007 envisages a surplus equivalent to 0.8% of GDP after allowing for a reduction of the corporate tax rate from 15% to 10%. The government plans to achieve the target through maintenance of its tight fiscal policies aimed to curb domestic demand. The target looks well within reach, given the ongoing fiscal developments.

## (3) Despite persistent current account deficit, external position remains solid

The current account deficit continued deteriorating on surging imports driven by strong domestic demand and higher energy prices. The current account deficit widened to 15.8% of GDP in 2006 from 12.0% the year before. The deterioration mainly stemmed from an increased trade deficit, which reached a level equivalent to 21.5% of GDP. While imports decelerated moderately on a weakening domestic demand, exports slowed down more steeply due mainly to the currency appreciation. Risks of refinancing the deficit remain restrained as net FDI inflows totaled a record EUR 4,227 million or 16.8% of GDP in 2006, more than enough to cover the deficit. Furthermore, net financial inflows involving portfolio investment and bank loans reached a new record of EUR 1,413 million. The foreign exchange reserves also soared to a record EUR 8,926 million at the end of 2006, enough to cover more than five months of imports.

The current account deficit may remain large for a while. However, it is likely to begin narrowing as exports pick up on expanded production capacity rendered by massive FDI inflows and imports decelerate on slower domestic demand.

## (4) JCR retains the ratings and outlooks

JCR will maintain both its ratings and outlooks. The country's sound fiscal policies, solid economic growth and strong external position will remain little changed in the immediate future. JCR considers that a further deterioration of the current account deficit can be halted in 2007. However, it will continue to pay attention to the coalition government's fiscal policies in the wake of the EU accession and reacceleration of bank lending to private sector.

### Main Economic Indicators: The Republic of Bulgaria

		2002	2003	2004	2005	2006	2007 (f)	2008 (f)
Real GDP growth rate	(%)	4.5	5.3	6.6	6.1	6.1	5.5	5.2
CPI (annual average)	(%)	5.8	2.4	6.2	5.0	7.3	5.2	3.5
Unemployment rate	(%)	18.1	13.7	12.0	10.1	9.1	8.2	7.6
General government balance/GDP	(%)	-0.9	0.0	1.7	2.3	3.6	2.2	1.6
General government debt/GDP	(%)	55.8	47.8	40.6	31.7	25.6	20.1	17.2
Current account balance	(EURmn)	-403	-973	-1,307	-2,622	-3,978	-3,744	-3,208
Current account balance/GDP	(%)	-2.4	-5.5	-6.6	-12.0	-15.8	-13.5	-10.6
Trade balance/GDP	(%)	-11.4	-13.7	-14.9	-20.2	-21.5	-18.9	-16.7
Net foreign direct investment	(EURmn)	951	1,827	2,252	3,178	4,227	3,600	3,000
Net foreign direct investment/GDP	(%)	5.7	10.3	11.3	14.5	16.8	13.0	10.4
Foreign exchange reserves (excl. gold)	(EURmn)	4,575	5,309	6,854	7,370	8,926	10,200	11,500
Import (G&S) coverage	(months)	5.6	5.7	6.1	5.3	5.2	5.2	5.2
Forex reserves / ST external debt	(times)	3.0	3.5	2.8	2.0	1.5	1.7	1.6
External debt/GDP	(%)	65.0	60.1	63.8	69.0	73.5	77.7	80.5
Net external debt/GDP	(%)	37.4	30.1	29.2	35.3	37.9	41.0	42.4
External debt/ exports (G&S)	(%)	126.4	113.2	112.5	115.8	115.5	114.1	111.8
External public debt/ exports (G&S)	(%)	87.7	70.5	53.2	33.9	23.9	17.4	13.8
Debt service ratio	(%)	16.5	14.2	23.2	43.8	31.3	23.8	23.0

(Note) Figures for 2007 and 2008 are projection made by JCR  
(Sources) Bulgarian National Bank, Ministry of Finance

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